EXECUTIVE SUMMARY

Recent Fiscal Developments and Outlook

Fiscal risks are abating somewhat but remain elevated. In advanced economies, recent policy moves have broadly stabilized public debt ratios, but medium-term prospects are still uncertain, and debt remains at historic highs. Fiscal vulnerabilities are rising in both emerging market economies and low-income countries, although in most cases from relatively moderate levels. Across country groups, fiscal policy should aim at rebuilding policy space while supporting the recovery and long-term growth prospects.

In most advanced economies, the pace of fiscal consolidation will slow in 2014 as average gross debt stabilizes and the focus shifts appropriately toward ensuring that the composition of adjustment supports the still uneven recovery. The main exception is Japan, where fiscal consolidation measures are projected to start this year. In most countries, persistently high debt ratios continue to cast shadows over the medium term, and risks to fiscal forecasts remain mostly on the downside, reflecting weak growth prospects, medium-term policy uncertainty, and persistent deflationary concerns with potentially deleterious impacts on debt dynamics and budget outturns. Against this background, the top priority remains the design and implementation of credible medium-term consolidation plans to lower debt ratios to safer levels, while carefully balancing equity and efficiency goals.

Among emerging market economies, deficits remain significantly above precrisis levels as most countries opted to postpone fiscal adjustment in 2014. In countries more closely integrated with international capital markets, the normalization of global liquidity conditions has begun to raise borrowing costs and financial volatility, giving yet greater urgency to fiscal consolidation, particularly where deficits and public debt have remained stubbornly high. More broadly, well-designed fiscal reform can help strengthen safety nets, boost potential growth, and prop up domestic saving where it has eroded.

Fiscal space is shrinking in many low-income countries as revenue mobilization has lagged behind fast spending growth. Reduced availability of aid resources and commodity price volatility remain key risks for these economies, calling for renewed efforts to step up the mobilization of domestic revenue, as well as for reforms to increase spending efficiency, including through the streamlining of subsidies. Although growth has been resilient so far, fiscal positions may deteriorate as the result of spillovers from a potential emerging market economy slowdown or from weak growth in advanced economies.

Expenditure Reform—Making Difficult Choices

Ensuring the sustainability of public finances requires difficult choices on both sides of the budget. While tax reform can help boost potential growth through the removal of distortions, spending reforms have a key role to play in strengthening public service delivery. This will be no easy task, however: even though country preferences about the size and functions of government do vary, as countries become richer, both the demand for public goods and services ("Wagner's law") and the cost of providing them ("Baumol's cost disease") increase relative to other goods and services produced in the economy. Coupled with the projected increase in age-related expenditures resulting from an aging population, pressures on government spending in the future can only go up.

Meaningful expenditure reform strategies essentially boil down to three main elements: ensuring the sustainability of social spending and the public wage bill—the main items in most governments' budgets; achieving efficiency gains while paying due regard to equity; and establishing institutions that promote spending control. Within these parameters, countries have substantial space to choose the desired level of provision of public services and spending priorities.

A focus on social spending and the government wage bill is warranted since these two items have been the main contributors to the trend increase in government expenditure in most countries. Past episodes of successful fiscal adjustments also suggest that reductions in these items have been the most durable and growth friendly. Containing the growth of the wage bill in a lasting way would require replacing the across-the-board wage and hiring freezes implemented in several countries since 2009 with deeper, efficiency-enhancing structural reforms. In those emerging market and developing economies where an expansion of public services is needed to boost potential growth, the associated increase in the public wage bill should be commensurate with the increased provision of services and a parallel increase in revenue.

Ensuring the long-term sustainability of public pension and health care systems—or increasing their coverage, where appropriate—involves careful prioritization. For pensions, raising the retirement age and adjusting contributions and benefits are the key options. Among these, gradually raising the retirement age while protecting the vulnerable seems to be the most attractive option. For public health care systems, evidence suggests that most countries have room to improve efficiency through greater competition and better regulation, among other measures. Improving efficiency would help contain the growth of health spending in advanced economies and generate savings to expand coverage in emerging market and developing economies.

Potential gains are also large from improving the efficiency of spending in the provision of education and in public investment, although the gains would vary across country groups. Containing the growth of per pupil spending by, for example, adjusting class sizes and rationalizing the education wage bill is crucial to accommodating the increased demand for education spending. In emerging market and developing economies, improving the efficiency of public investment processes could make it easier to meet infrastructure demands. In advanced economies, where inefficiencies in public investment are more limited, greater public investment or greater involvement of the private sector will be necessary to arrest the trend decline in the stock of public capital and to support growth.

Finally, the success of expenditure reforms will depend in large part on the institutional framework within which they will be implemented. Two aspects have been found to be particularly important. First, public financial management systems can help mitigate incentives to overspend and misallocate public funds. In particular, fiscal rules, including expenditure rules, can impose binding commitments and constraints on the path of public spending. Second, a well-designed fiscal decentralization framework could foster the effective implementation of spending reforms, while ensuring the adequate provision of public services, although the degree of decentralization ultimately remains a country-specific political choice. In addition, expenditure reforms are more likely to be successful and long-lasting if supported by extensive political consensus building and a broad communications strategy.